

June 1984

Taxation: The Foglesong Saga Continues

Jerrold H. Kohn

Douglas W. Trabaris

Follow this and additional works at: <https://scholarship.kentlaw.iit.edu/cklawreview>



Part of the [Law Commons](#)

Recommended Citation

Jerrold H. Kohn & Douglas W. Trabaris, *Taxation: The Foglesong Saga Continues*, 60 Chi.-Kent L. Rev. 629 (1984).

Available at: <https://scholarship.kentlaw.iit.edu/cklawreview/vol60/iss3/7>

This Article is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Chicago-Kent Law Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact jwenger@kentlaw.iit.edu, ebarney@kentlaw.iit.edu.

TAXATION: THE *FOGLESONG* SAGA CONTINUES

JERROLD H. KOHN,*
DOUGLAS W. TRABARIS**

In the 1982-83 term¹ the United States Court of Appeals for the Seventh Circuit decided several significant tax cases. This article will discuss the decisions dealing with the validity of personal service corporations;² the ability of a corporation to amortize a bond premium;³ whether two related transactions, a tax-free merger and a subsequent sale of acquired stock, should be treated as a single purchase transaction;⁴ how to value non-voting shares for estate tax purposes when the decedent owns a majority of the voting shares;⁵ whether extra-ordinary prepublication expenses have to be capitalized by the publisher;⁶ and whether estimated taxes are payable on recapture of investment tax credits.⁷

THE VALIDITY OF PERSONAL SERVICE CORPORATIONS

Although the continued acceptability of personal service corporations has recently been subject to doubt because of the passage of section 269A of the Internal Revenue Code (I.R.C.), *Foglesong v. Commissioner*⁸ illustrates the underlying vitality that still exists in the policy favoring valid personal service corporations. *Foglesong* shows that tax advantages are available for incorporating a one-person business as long as the corporation receives its income from more than one

* B.S., Accounting, Northern Illinois University, 1980; C.P.A., 1980; Candidate for J.D., IIT Chicago-Kent College of Law, 1984.

** B.A., History, University of Illinois-Urbana, 1981; Candidate for J.D., IIT Chicago-Kent College of Law, 1984.

1. This article discusses tax cases decided by the Seventh Circuit between June 1, 1982 and May 31, 1983.

2. *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982). See *infra* notes 8 to 90 and accompanying text.

3. *National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982). See *infra* notes 91 to 143 and accompanying text.

4. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982). See *infra* notes 144 to 180 and accompanying text.

5. *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983). See *infra* notes 181 to 192 and accompanying text.

6. *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982). See *infra* notes 193 to 201 and accompanying text.

7. *A.O. Smith Corp. v. United States*, 691 F.2d 1220 (7th Cir. 1982). See *infra* notes 202 to 214 and accompanying text.

8. 691 F.2d 848 (7th Cir. 1982).

source⁹ and the employee works exclusively for a bona fide corporation.¹⁰

I.R.C. § 482,¹¹ which covers personal service corporations, provides that the I.R.S. may distribute, apportion or allocate gross income, deductions, credits or allowances between or among two or more entities owned or controlled by the same interests if such a distribution, apportionment or allocation is necessary to prevent evasion of taxes or to accurately reflect the income of the entities. The I.R.S. has the discretion to decide whether the taxpayer intends to evade taxes and what properly reflects income.¹² A two-prong test is used to determine the application of section 482. The first prong is whether the taxpayer is in two or more businesses controlled by the same interests.¹³ The second prong is whether the remuneration the person received after incorporation is less than he otherwise would have received.¹⁴

The traditional application of the "two-business" rule can be found in *Borge v. Commissioner*.¹⁵ There, a professional entertainer incorporated himself and a poultry business.¹⁶ The losses of the poultry business were used to partially offset Borge's entertaining profits.¹⁷ The two business requirement is invoked when a person engages in two endeavors that are under the common control of one personal service corporation.¹⁸ Because of Borge's disparate activities conducted under the umbrella of his personal service corporation, the court ruled that he controlled two separate businesses, hence, the losses were disallowed.¹⁹

Since *Borge* the scope of the two businesses rule has been further

9. *Id.* at 851 n.3.

10. *Id.* at 852.

11. I.R.C. § 482 (1983). Unless otherwise stated, Code references are to sections of the Internal Revenue Code (I.R.C.) of 1954, as amended.

12. Treas. Reg. § 1.482-1(b)(1) (1983).

13. I.R.C. § 482. See Fuller, *Section 482 Revisited*, 31 TAX L. REV. 475, 477-486 (1976).

14. I.R.C. § 482. See Rubin v. Commissioner, 460 F.2d 1216, 1218 (2d Cir. 1972); Borge v. Commissioner, 405 F.2d 673, 677 (2d Cir. 1968); Pacella v. Commissioner, 78 T.C. 604, 619-620 (1982); Keller v. Commissioner, 77 T.C. 1014, 1025 (1981); Achiro v. Commissioner, 77 T.C. 881, 897 (1983); Ach v. Commissioner, 42 T.C. 114, 125-126 (1964), *aff'd* 358 F.2d 342 (6th Cir. 1966). See also Fuller, *Section 482 Revisited*, 31 TAX L. REV. 475, 486-491 (1976). The Income Tax Regulations consider the difference between the salary which would be received without incorporation and that received when incorporated in a transaction which may not be at arm's length. See Treas. Reg. § 1.482-2(b)(3) (1983).

15. 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969).

16. 405 F.2d at 674-75.

17. *Id.* at 675. Borge and his corporation entered into a five year contract which set his salary at \$50,000 a year. The net entertainment income of Borge's corporation averaged \$166,456 a year during that five-year period. The losses of the poultry farm averaged \$132,151 per year during that same time period. Thus, because of these high losses in the poultry business, Borge was only paid his salary in one year. *Id.*

18. *Id.*

19. *Id.*

expanded. In *Commissioner v. Keller*²⁰ the tax court approved the use of the rule to a situation where the owner of a personal service corporation carried on one business. Keller, a doctor, incorporated himself to take advantage of the benefits available to corporate employees.²¹ Although Keller did not carry on two different businesses, the court found two separate businesses for purposes of I.R.C. § 482.²² The *Keller* result means that the sole employee and his personal service corporation can be considered in separate businesses although he works exclusively for it and carries on no other business activities.

If the employee of the personal service corporation received substantially less than he would have absent incorporation, then the second prong of the test under I.R.C. § 482 is applied to allocate the income.²³ In *Borge*,²⁴ for example, the income of the personal service corporation was over three times as high as the salary paid to its sole employee.²⁵ I.R.C. § 482 was used to allocate to Borge some of the income he originally kept with his corporation. For the same reasons as *Borge*, in *Rubin v. Commissioner*²⁶ the sole employee of a management service corporation was held to be underpaid.

However, some recent cases have held that even though the salary paid after incorporation is less than that before, I.R.C. § 482 will not always reallocate the income.²⁷ Such cases compare the difference in the level of compensation with the amount of taxes paid when incorporated or not.²⁸ This dichotomy may be relevant, for example, because pension plan contributions for someone who is incorporated "may be worth more to a high-bracket taxpayer than outright taxable payments of an equivalent amount."²⁹

The broad reach of I.R.C. § 482 in recent cases finally has been clarified. *Foglesong v. Commissioner* attempts to reach a middle ground in the application of I.R.C. § 482.

20. 77 T.C. 1014 (1981).

21. *Id.* at 1016. Among the benefits that Dr. Keller adopted were an employee wage continuation plan and a defined benefit pension plan and trust. *Id.*

22. *Id.* at 1022-23.

23. See *supra* note 14 for a listing of cases which utilize this test.

24. 405 F.2d 673 (2d Cir. 1968).

25. *Id.* at 675. See *supra* note 17 for the salary paid to Borge and how much he earned for his corporation.

26. 460 F.2d 1216 (2d Cir. 1968). Rubin's management services earned his company \$35,539.12 in 1960 and \$27,488.34 in 1961. Rubin was paid a salary of \$8,750 in 1960 and \$6,900 in 1961. *Id.* at 1217.

27. *Pacella v. Commissioner*, 78 T.C. 604 (1982); *Keller v. Commissioner*, 77 T.C. 1014 (1981).

28. *Pacella v. Commissioner*, 78 T.C. at 621. See *Keller v. Commissioner*, 77 T.C. at 1028.

29. *Pacella v. Commissioner*, 78 T.C. at 621.

Frederick A. Foglesong was a sales representative for two manufacturers of cold drawn steel tubing.³⁰ On August 30, 1966, Foglesong incorporated his business as Frederick H. Foglesong Company, Inc., a personal service corporation.³¹ Foglesong owned 98% of the stock, with the remainder split between his wife and accountant.³² His children held preferred stock and received dividends between September 1, 1966 and December 31, 1969.³³

Foglesong worked exclusively for his company, and was not involved in any other business activities. He did not have a written employment contract with the corporation.³⁴ All payments for work that Foglesong performed were paid to his personal service corporation, including some money due him for work done prior to incorporation.³⁵ The corporation paid Foglesong a monthly salary, beginning in January, 1967.³⁶

In 1973, the Commissioner of Internal Revenue sent Foglesong tax-deficiency notices.³⁷ The tax court agreed with the Commissioner in finding that the taxpayer's primary motive in forming the corporation was to avoid income taxes.³⁸ The court ruled that the income reported by the corporation should have been reported by the taxpayer under the assignment of income theory³⁹ and section 61.⁴⁰

The tax court's decision was reversed by the Seventh Circuit Court of Appeals.⁴¹ The appellate court found that the corporation was not a

30. Foglesong v. Commissioner, 691 F.2d 848, 850 (7th Cir. 1983).

31. Foglesong v. Commissioner, 621 F.2d 865, 866 (7th Cir. 1980), *remanded*, Frederick H. Foglesong, 77 T.C. 1102 (1981), *rev'd*, Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1983).

32. 691 F.2d at 850.

33. *Id.*

34. *Id.*

35. *Id.* The entire income of Foglesong, and later his corporation, was derived from two customers: Plymouth Tube, a division of Van Pelt Corporation, and Pittsburgh Tube Company. Both customers had written contracts with Foglesong prior to incorporation. They did not sign written agreements with Foglesong's personal service corporation until several years after it was incorporated. Frederick H. Foglesong, 35 T.C.M. 1309, 1310-11 (1976).

36. 691 F.2d at 850. The court's opinion states January, 1977 as the time Foglesong began receiving his monthly salary. This is incorrect. The corporation started paying Foglesong a salary in 1967.

37. *Id.* at 849.

38. Frederick H. Foglesong, 35 T.C.M. 1309, 1313 (1976).

39. *Id.* The assignment of income theory provides that a taxpayer cannot assign his income to another individual or entity to avoid taxes. See *Lucas v. Earl*, 281 U.S. 111 (1930) (earnings must be taxed to the person who earns them; taxes, therefore, cannot be avoided by anticipatory arrangements and contracts). See also Chapman, *The Future of Personal Service Corporations*, 24 ARIZ. L. REV. 503 (1982); Fever, Section 482, *Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981).

40. I.R.C. § 61 (1983) broadly defines gross income as "all income from whatever source derived."

41. Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980).

sham.⁴² Not only did Foglesong work exclusively for his personal service corporation, but it, not Foglesong, entered into contracts with customers and suppliers.⁴³ The court remanded the case for determination whether, under I.R.C. § 482, the corporation's income could be attributed to Foglesong.⁴⁴

The tax court, on remand, held that I.R.C. § 482 applied.⁴⁵ The court noted that the scope of I.R.C. § 482 is broad because it is designed to encompass all kinds of business activity.⁴⁶ Therefore, 98% of the corporation's taxable income was allocated to Foglesong.⁴⁷

In an opinion by Judge Pell, the Seventh Circuit Court of Appeals reversed the decision of the tax court.⁴⁸ The case was again remanded to consider whether assignment of income principles can be used to allocate the preferred stock and dividends received by Foglesong's children to Foglesong; and how to apportion the commissions paid to the corporation but earned by Foglesong prior to incorporation.⁴⁹

The Seventh Circuit court held that I.R.C. § 482 cannot be applied to allocate income where a person works exclusively for a personal service corporation.⁵⁰ The court stated that the tax court gave an overly broad interpretation to the statute⁵¹ by determining that I.R.C. § 482 applies to any kind of entity or business which has independent tax significance⁵² and where evasion of taxes is found.⁵³ This means,

42. The district court also found that the company was not a sham, but decided that tax-avoidance was the primary reason for incorporation. 35 T.C.M. at 1313. The Seventh Circuit, on the other hand, held that the corporation's legitimacy overrides the realistic assumption that tax minimization was an important factor in Foglesong's decision to form a personal service corporation. 621 F.2d at 872-73.

43. 621 F.2d at 866-68. The court felt that this case recognized "some vitality in personal service corporations," and that the corporation was legitimate. *Id.* at 873. The dissent stated that the corporation was used for tax-avoidance purposes. *Id.* (Wood, J.).

44. *Id.*

45. Frederick H. Foglesong, 77 T.C. 1102 (1981).

46. *Id.* at 1104, quoting H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934).

47. 77 T.C. at 1103. The 98% allocation to Foglesong was not expressly stated in the opinion, but was the result of the court's reasoning as it applied to the facts presented.

48. Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982).

49. *Id.* at 852.

50. *Id.* at 851.

51. *Id.*

52. 77 T.C. at 1104. The tax court relied on a congressional committee report that stated section 482 was intended to cover "all kinds of business activity." H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934). This report, the appeals court in Foglesong emphasized, was read out of context by the tax court. The statement concerning "all kinds of business activity" was only used in explaining the inclusion of "organizations" in I.R.C. § 482, not in the application of section 482 to all possible entities with independent tax significance. 691 F.2d at 851.

53. 77 T.C. at 1105. Although the tax court ruled that Foglesong's personal service corporation was not a sham, the fact that absent incorporation he would have earned an additional \$212,000 illustrates his "tax-avoidance" purpose in incorporating. *Id.* at 1106.

the tax court reasoned, that a corporation and its sole employee can be interpreted to be in a separate trade or business for purposes of applying I.R.C. § 482 even where the employee works exclusively for his personal service corporation.⁵⁴

The Court of Appeals ruled that I.R.C. § 482 should not be applied this liberally.⁵⁵ I.R.C. § 482 is designed to be used where an employee of a personal service corporation does not work exclusively for it or to prevent profits from one business being used to offset the losses of another.⁵⁶ This, the court determined, would not only satisfy the terms of the statute, but also adhere to the policy that legitimate personal service corporations should be recognized.⁵⁷

Relying on the exclusivity requirement of I.R.C. § 482, the court distinguished three cases the Commissioner tried to apply to *Foglesong*.⁵⁸ The court differentiated *Borge*⁵⁹ from the instant case for several reasons. Foglesong, unlike Borge, worked exclusively for his corporation.⁶⁰ Foglesong had no other line of work, whereas Borge was an entertainer besides running a poultry farm.⁶¹ Additionally, Borge offset the losses of his farming business against his performing income.⁶² Foglesong made no similar offset.⁶³

Similarly, in *Ach v. Commissioner*,⁶⁴ I.R.C. § 482 was applied where the taxpayer offset the earnings of a dress business with an unprofitable dairy corporation by combining them into one corporation and discontinuing the dairy venture.⁶⁵ The *Foglesong* court distinguished the present situation by stating that not only had Foglesong not shifted the profits of one business with another, but unlike Ach, Foglesong was paid a salary.⁶⁶ The fact that neither Ach nor Foglesong had an employment contract with their personal service corporations is not

54. *Foglesong v. Commissioner*, 691 F.2d at 850.

55. *Id.* at 851.

56. *Id.* at 852.

57. *Id.* at 851. See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *O'Neill v. United States*, 410 F.2d 888 (6th Cir. 1969); Rev. Rul. 70-101, 1970-1 C.B. 278.

58. 691 F.2d at 851-52. *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969); *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966); *Rubin v. Commissioner*, 56 T.C. 1155 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972).

59. 405 F.2d 673 (2d Cir. 1968).

60. *Foglesong v. Commissioner*, 691 F.2d at 851.

61. *Id.* at 851-52.

62. *Id.*

63. *Id.*

64. 42 T.C. 114 (1964).

65. 42 T.C. at 126.

66. 691 F.2d at 852.

analogous because Foglesong's exclusive performance for his corporation is more significant than any paper obligation.⁶⁷ Ach, on the other hand, could not claim exclusive performance or proper compensation to offset the lack of a formal employment contract.⁶⁸

The significance of exclusivity of employment was also mentioned in *Rubin v. Commissioner*.⁶⁹ The *Foglesong* court stressed the *Rubin* court's observation that I.R.C. § 482 should be applied where the taxpayer receives income from work other than that performed for his personal service corporation.⁷⁰ In *Rubin*, unlike *Foglesong*, the taxpayer earned more than \$25,000 from work not performed for his corporation.⁷¹

In addition to distinguishing the three cases, the *Foglesong* court also held that I.R.C. § 269A⁷² was not applicable in the instant case.⁷³ I.R.C. § 269A deals with personal service corporations formed or used to avoid taxes.⁷⁴ The ambit of I.R.C. § 269A extends to situations where substantially all the corporation's services are performed for, or on behalf of, another corporation or business entity.⁷⁵ After discounting the use of I.R.C. § 269A, the court, based on the foregoing, concluded that I.R.C. § 482 should not be applied because Foglesong worked exclusively for his personal service corporation and there was

67. *Id.*

68. *Id.*

69. 56 T.C. 1155 (1971).

70. *Foglesong v. Commissioner*, 691 F.2d at 852. In fact, the *Foglesong* court quoted a portion of the *Rubin* opinion that stated:

That where the particular facts of a case are such as to justify a finding that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business to which allocation of all or part of the income attributable to his efforts is authorized under section 482.

Id., quoting, *Rubin v. Commissioner*, 56 T.C. at 1161.

71. 691 F.2d at 852.

72. I.R.C. § 269A (1983) provides:

(a) General Rule—If—

- (1) substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership, or other entity, and
- (2) the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available, then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of personal service corporation or any of its employee-owners.

73. 691 F.2d at 852 n.3. The tax years in dispute occurred prior to December 31, 1982, the effective date of § 269A.

74. I.R.C. § 269A (1983).

75. *Id.*

no shifting of income to reduce tax liability.⁷⁶

In a one-sentence dissenting opinion, Judge Cummings agreed with the dissent in the earlier Seventh Circuit opinion of *Foglesong* written by Judge Wood.⁷⁷ Judge Wood held that Foglesong's personal service corporation "is nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due."⁷⁸ As a result, Foglesong used this "make-believe corporation" to divert to his children over \$8,000 of his own income.⁷⁹ Hence, I.R.C. § 482 should apply.⁸⁰

Foglesong represents a timely moderation in the scope of I.R.C. § 482 and the taxation of personal service corporations. The thrust of I.R.C. § 482 has been rightfully stemmed. As previously noted, the *Keller* decision broadened the application of I.R.C. § 482 to situations where the sole employee of a personal service corporation who works exclusively for it is considered in a separate trade or business for purposes of meeting the dual business requirement.⁸¹ *Foglesong* rightfully recognized that I.R.C. § 482 is used to allocate income of a person who does *not* exclusively work for his personal service corporation.⁸² A literal reading of the statute requires this result.⁸³ A person fulfills the dual business requirement of I.R.C. § 482 when, such as in *Borge*, he works in two businesses that are incorporated together.⁸⁴

Does the result of *Foglesong* threaten a "serious abuse of the tax laws"?⁸⁵ The impact of the case, despite its condemnation by the dissenters, is surprisingly limited. Although limiting the application of I.R.C. § 482, *Foglesong* will not result in a proliferation of sham corporations.

What *Foglesong* represents is the acquiescence by the court in allowing formation of a personal service corporation in order for a tax-

76. 691 F.2d at 852.

77. *Id.* at 852-53.

78. *Foglesong v. Commissioner*, 621 F.2d 865, 873 (Wood, J., dissenting).

79. *Id.*

80. *Id.* A rehearing *en banc* was denied. Judges Cudahy, Cummings and Wood dissented from this decision and published a short opinion by Judge Cudahy stating, in part, that the decision of the court condones, "a serious abuse of the tax laws and may be precedent for dangerous attacks on the integrity of the revenue system." 691 F.2d at 853.

81. See *supra* notes 20-22 and accompanying text.

82. 691 F.2d at 851. The *Foglesong* court found two valid reasons for reaching this conclusion. First, the terms of the statute are clearly fulfilled by a reading of section 482. Second, the result supports the policy that legitimate personal service corporations should be recognized. *Id.*

83. See *supra* notes 11 to 14, and accompanying text for discussion of the contents of § 482.

84. *Borge's* personal service corporation encompassed his entertaining revenues and a poultry business. *Borge v. Commissioner*, 405 F.2d 673 (1968).

85. 691 F.2d at 853.

payer to avail himself of the benefits of incorporation.⁸⁶ As long as the corporate formalities are met and the employee works exclusively for his company in only one trade or business, such a corporation is not considered a sham. I.R.C. § 482 will not cause allocation of the personal service corporation's income where the aggregate compensation received by the employee-owner is approximately equivalent to the total earnings of the corporation.⁸⁷

These benefits, however, do not extend to all personal service corporations. I.R.C. § 269A prevents personal service corporations formed principally to avoid taxes.⁸⁸ More specifically, results like the *Keller* case, where a personal service corporation is paid by one source, will no longer be allowed.⁸⁹ Foglesong's personal service corporation, unlike Keller's, does business with more than one company.⁹⁰ I.R.C. § 269A will not restrict future formation of personal service corporations in situations analogous to Foglesong's.

The personal service corporation is still a valid tax-savings device in the Seventh Circuit. Reaping the benefits of incorporating a one-person corporation is acceptable if: (1) the personal service corporation pays its owner-employee roughly the same amount that he would make

86. Considering the limitations I.R.C. § 269A imposed on personal service corporations regarding retirement planning and employee benefits, incorporation no longer is as desirable as it once was. See Chapman, *The Future of Personal Service Corporations*, 24 ARIZ. L. REV. 503 (1982). However, Professor Chapman points out some remaining advantages. For example, he states:

if an individual expects to incur or to pay substantial medical expenses, for example, tax benefits that may be derived from a medical expense reimbursement plan alone may make incorporation worthwhile. In addition, lower corporate rates, the availability of insurance plans, and the possibility of deferring most of one year's tax provide some additional potential benefits. Limited liability, although restricted for a professional corporation by most states, and the other non-tax benefits of corporations provide additional considerations. On the other hand, the potential disadvantages of incorporation are relatively few and inexpensive.

Id. at 529.

87. 691 F.2d at 853. The benefit of incorporating to lower your tax rate, therefore, is not available because the salary paid as an employee of a personal service corporation has to be substantially the same as that paid before incorporation. Of course, other benefits on incorporation are still available, so that tax evasion is not necessarily the primary purpose of incorporation. Rather, as long as the corporation meets the requisite formalities and the sole reason for incorporation is not tax evasion (as evidenced by a salary that is substantially equal both before and after incorporation), then a serious abuse of the tax laws, despite the views of the rehearing dissenters, is not occurring.

88. I.R.C. § 269A (1983).

89. *Keller v. Commissioner*, 77 T.C. 1014 (1981), was expressly overruled by I.R.C. § 269A. Congress intended to eliminate the principal advantages of incorporating in situations similar to those in *Keller*. See H.R. REP. NO. 760, 97th Cong., 2d Sess. (1982).

90. Dr. Keller, a pathologist, had a personal service corporation act as a substitute partner for him in a medical partnership. The corporation was only receiving money from one source and Dr. Keller admitted his primary reason for incorporating was to take advantage of the tax benefits. *Keller v. Commissioner*, 77 T.C. at 1016-17.

without incorporation; (2) the corporate formalities are observed; (3) the employee works exclusively for his company; and (4) the personal service corporation receives income from more than one source. Neither I.R.C. § 482 nor, in most instances, I.R.C. § 269A, cause allocation of the income from the corporation to its employee.

DEDUCTIBILITY OF PREMIUM PAID BY PARENT CORPORATION WHEN
ACQUIRING SUBSIDIARY'S CONVERTIBLE BONDS IN
EXCHANGE FOR PARENT'S COMMON STOCK

In *National Can Corporation v. United States*,⁹¹ the Seventh Circuit was asked to rule on the application of an Internal Revenue Code section on bond premium amortization⁹² to a complex set of facts. The court held that when a corporation issues stock to satisfy the conversion feature of convertible bonds, the excess of the fair market value of the stock over the face value of the bonds is not deductible as amortizable bond premium.⁹³ The reason is that under I.R.C. § 171(b),⁹⁴ the premium was related to the conversion feature of the bond, rather than to market rates of interest.⁹⁵ In so holding, the court rejected several arguments advanced by the taxpayer that the excess paid for the acquisition of the bonds should be amortized despite the limiting provision in I.R.C. § 171(b). The court also rejected the argument that the excess paid over the face value of the bonds was an ordinary and necessary business expense under I.R.C. § 162.⁹⁶

National Can Corporation (National Can) is a manufacturer of various plastic and metal containers. In 1967, National Can decided to acquire a British can manufacturer, Clover Industries, Ltd. (Clover). To facilitate this purchase, National Can organized a separate subsidiary known as National Can Overseas Corporation (NCOC).⁹⁷

91. 687 F.2d 1107 (7th Cir. 1982).

92. See I.R.C. § 171 (1983).

93. *National Can Corporation v. United States*, 687 F.2d 1107 (7th Cir. 1982).

94. I.R.C. § 171(b) (1983).

95. I.R.C. § 171(b) states, in part, "[i]n no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond."

96. I.R.C. § 162(a) (1983).

97. NCOC was organized because National Can planned to finance the purchase by borrowing Eurodollars (U.S. dollars held by Europeans). Eurodollars were used in order to comply with the United States Government's voluntary program on controlling the balance of payments. *National Can*, 687 F.2d at 1108. However, in order to avoid having to withhold income taxes on interest paid to foreign lenders as required by I.R.C. § 871(a)(1)(A) (1983), NCOC was organized as a "20/80 corporation," in which 20% or less of its income would be received from U.S. sources. *National Can*, 687 F.2d at 1109. Under I.R.C. § 861(a)(1)(B) (1983), such corporations are not required to withhold income taxes on amounts paid to foreign sources. For an in-depth study of so-called "international finance subsidiaries," see Fox, *Financing Foreign Operations Through Domestic Finance Subsidiaries*, 55 VA. L. REV. 1306 (1969).

In late 1967, several U.S. banks loaned money to NCOC on an interim basis. NCOC used these funds to purchase Clover.⁹⁸ National Can guaranteed payment of these loans. The loans were structured to be repaid from the proceeds of a 20-year issue of debentures by NCOC to foreign holders of Eurodollars.⁹⁹

The proceeds received by NCOC on the sale of the debentures was \$6,825,000. The debentures were payable on December 1, 1987. After June 1, 1967, they were convertible into one share of National Can common stock for every \$19.25¹⁰⁰ worth of debentures. Once converted, the debentures were not further convertible, and could not be transferred except between National Can and NCOC.¹⁰¹ National Can guaranteed payment of principal and interest on the debentures. They also guaranteed NCOC's obligation to convert the debentures into National Can common stock. Pursuant to this guarantee, National Can reserved 181,818 shares of common stock.¹⁰²

From 1969 through 1971, many of the debenture purchasers exercised their conversion option. NCOC did not hold any National Can stock, so National Can, pursuant to its guarantee, issued its common stock upon presentation of the debentures. On the dates most of these conversion rights were exercised, the fair market value of National Can's common stock exceeded the conversion price. Specifically, the fair market value of the stock issued for the debentures exceeded the face amount of the debentures by a total of \$3,793,544.¹⁰³ National Can treated this excess as bond premium and amortized it over the remaining life of the debentures. The I.R.S. disallowed the deductions and assessed deficiencies. National Can paid the deficiencies and sued for a refund in the district court,¹⁰⁴ which ruled in favor of the Government.¹⁰⁵

98. *National Can*, 687 F.2d at 1109. NCOC actually formed an English subsidiary which then purchased over 90% of Clover's stock. *Id.*

99. *Id.*

100. The original exchange price was \$38.50, but was reduced as a result of a two-for-one stock split on June 3, 1970. *Id.*

101. *Id.*

102. *Id.* at 1110.

103. For a detailed breakdown of this amount, see 687 F.2d at 1110.

104. *Id.*

105. *National Can Corp. v. United States*, 520 F. Supp. 567 (N.D. Ill. 1981). In addition to arguing that the excess paid was bond premium within I.R.C. § 171 or an ordinary and necessary business expense under I.R.C. § 162(a), National Can argued that NCOC should be permitted to deduct as bond discount the difference between the face value of the debentures and the amount they would have been sold for if issued without conversion rights pursuant to I.R.C. § 1232. *National Can*, 520 F. Supp. at 572. The district court rejected this argument. 520 F. Supp. at 572-76. This issue was not raised on appeal.

I.R.C. § 171¹⁰⁶ allows the purchaser of a bond to elect to amortize any premium over the life of the bond. Thus, if a taxpayer so elects,¹⁰⁷ a deduction will be allowed ratably over the life of the bond, rather than waiting until maturity¹⁰⁸ and including the entire premium as part of the bond's basis for determining a capital loss.

Prior to 1942, there was no provision in the Code for amortizing bond premium. The reasons for adopting the provisions of I.R.C. § 171 were twofold. First, treating the amount of periodic interest received as fully taxable is unsound tax practice because a portion of those interest payments are really a return of capital in the form of the premium paid.¹⁰⁹ Second, this resulted in unfair discrimination in favor of holders of tax-exempt bonds, because they are permitted to deduct the premium at maturity as a capital loss, while receiving periodic interest payments tax-free.¹¹⁰ This led to the adoption in 1942 of what is essentially the present version of I.R.C. § 171. However, there was no provision for discriminating between premium paid because of higher interest rates and premium paid due to the conversion feature of a convertible bond.

In 1950, the United States Supreme Court held in *Commissioner v. Korell*¹¹¹ that a taxpayer may elect to amortize bond premium *regardless* of the fact that the premium was paid for the conversion feature of the bond.¹¹² The Court's rationale was based on the language of the statute and its legislative history. The Committee Reports stated that if a bond is convertible, this does not prevent the application of I.R.C. § 171. If the option to convert rests with the owner of the bond, then it falls within the scope of this provision.¹¹³ The Court believed that Congress made no attempt to distinguish among the reasons why a pre-

106. I.R.C. § 171 (1983).

107. This provision does not apply to tax-exempt bonds. I.R.C. § 171(a)(2) (1983). I.R.C. § 171 will apply to partially tax-exempt bonds. Treas. Reg. § 1.171-1(a)(1)(ii), -1(a)(2)(ii) (1983).

108. The election to amortize the premium is optional; once made, however, it must apply to all bonds held by the taxpayer and can only be revoked if the Secretary so permits. I.R.C. § 171(c) (1983). The amortization of bond premium is mandatory with respect to tax-exempt bonds. Treas. Reg. § 1.171-1(a)(1)(i) (1983).

109. In addition to determining bond premium based on the maturity date of the bonds, the amount of premium is also determined with reference to any earlier call date. I.R.C. § 171(b)(1)(B). See Treas. Reg. § 1.171-2(a)(2)-2(b) (1983), for examples of determining the amount of a premium on a callable bond.

110. H.R. REP. NO. 2333, 77th Cong., 1st Sess. (1942); C.B. 372, 410 (1942). See also *Commissioner v. Shoong*, 177 F.2d 131, 133 (9th Cir. 1942), *rev'd*, 339 U.S. 974 (1950).

111. 339 U.S. 619 (1950).

112. *Id.* at 628.

113. H.R. REP. NO. 2333, 77th Cong., 2d Sess. 80 (1942). See also S. REP. NO. 1631, 77th Cong., 2d Sess. 94 (1942).

mium was paid.¹¹⁴ Congress immediately reacted to the *Korell* decision, amending I.R.C. § 171 to read: “[i]n no case shall the amount of a bond premium on a convertible bond include any amount attributable to the conversion features of the bond.”¹¹⁵ The House and Senate Reports stated that the bond premium deduction was paid as a result of an interest rate higher than market rates.¹¹⁶

In *National Can Corporation v. United States*,¹¹⁷ the taxpayer advanced three theories arguing that the exclusionary provision in I.R.C. § 171(b)¹¹⁸ should not apply. National Can first argued that the language of the exclusionary provision applies only to “convertible bonds”—i.e., bonds which are convertible in the hands of the party claiming the deduction.¹¹⁹ This was not the case under these facts, National Can argued, because the terms of the debentures stated that once converted, they were not further convertible. Because National Can had already converted the bonds, they were effectively holding non-convertible bonds.

The Seventh Circuit hypothesized that the district court¹²⁰ construed the term “convertible” to mean a bond which could be converted into common stock *at some time*. Thus, it was irrelevant when the bonds were actually converted, if at all. Although not incorrect, the district court’s reasoning was more basic than this. It was guided by the legislative history of the exclusionary provision, which stated that the purpose of the provision was to limit amortization to those situations where a premium is paid as a result of market rates which are lower than the rate of interest on the bond.¹²¹

National Can’s second argument rested on a treasury regulation

114. In the companion case to *Korell*, the Supreme Court reversed an appellate court decision holding that § 171 was not intended to allow amortization of a premium paid due to the conversion feature of a bond. *Shoong v. Commissioner*, 339 U.S. 974 (1950), *rev’g* 177 F.2d 131 (9th Cir. 1949). In *Shoong*, the Ninth Circuit found that the legislative history (discussed in the text accompanying note 113) means that a convertible bond will fall within the purview of section 171 *to the extent of any premium paid as a result of higher than market rates of interest*. *Commissioner v. Shoong*, 177 F.2d 131, 135 (9th Cir. 1949) (emphasis added). The reasoning in *Shoong* was the basis for Justice Black’s dissent in both *Korell* and *Shoong*.

115. I.R.C. § 171(b) (1983).

116. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 47-58 (1950).

117. 687 F.2d 1107 (7th Cir. 1982).

118. I.R.C. § 171(b) (1983).

119. *National Can*, 687 F.2d at 1111.

120. *National Can Corporation v. United States*, 520 F. Supp. 567 (N.D. Ill. 1981).

121. *National Can Corporation v. United States*, 687 F.2d 1107, 1111-12 (7th Cir. 1982), *citing*, *National Can Corporation v. United States*, 520 F. Supp. 567, 578 (N.D. Ill. 1981). The Seventh Circuit also found that I.R.C. § 171(b) to be ambiguous. They pointed out that the provision could have been drafted 1) without the term “convertible bonds,” so that it would be clear that it applied to a conversion feature whether or not the bond was convertible in the hands of the holder; or 2) to refer to “bonds with outstanding conversion features,” in support of National

which states "[a] convertible bond is within the scope of [I.R.C. § 171] if the option to convert . . . rests with the holder thereof."¹²² National Can again argued that the exclusionary provision of I.R.C. § 171(b) was only intended to apply to bonds with unexercised conversion features. As further support, National Can argued that a previous Seventh Circuit decision, *Roberts & Porter, Inc. v. Commissioner*,¹²³ stated that Congress enacted the exclusionary provision "to eliminate amortization . . . attributable to the conversion feature of convertible bonds, by the holders of such bonds."¹²⁴

The Seventh Circuit rejected National Can's reading of *Roberts & Porter* by pointing out that the language in the regulation is interpreting all of I.R.C. § 171, not just the exclusionary provision in I.R.C. § 171(b). The regulation simply indicates that a bond holder may amortize a premium paid as a result of lower market rates of interest *even though the bond also has a conversion feature*.¹²⁵ Furthermore, the sentence following that cited by National Can re-emphasizes that the amount of bond premium attributable to the conversion feature is not deductible.¹²⁶ The court also noted that the statement in *Roberts & Porter*, while correct, does not necessarily apply solely to holders of unexercised conversion rights.¹²⁷ *Roberts & Porter* involved a deduction for ordinary and necessary business expenses under I.R.C. § 162(a) of the Code.¹²⁸

The third argument made by National Can was that the exclusionary provision in I.R.C. § 171(b) applies only to a premium paid to acquire a conversion right, not when paid to extinguish one.¹²⁹ In support of this argument, National Can pointed to the legislative history of the exclusionary provision. The House and Senate reports state that the "premium paid may represent nothing more or less than the portion of the price paid for the security into which the bond is convert-

Can's argument that it does not apply to bonds which are no longer convertible in the hands of the party claiming the deduction. *National Can*, 687 F.2d at 1112.

122. Treas. Reg. § 1.171-2(c)(1) (1983).

123. 307 F.2d 745 (7th Cir. 1962).

124. *Id.* at 747 (emphasis supplied).

125. *National Can*, 687 F.2d at 1112. This meaning is evident from a casual reading of the first sentence of Treas. Reg. § 1.171-2(c)(1) (1983), which states, "[t]he fact that a bond is convertible into stock does not, in itself, prevent the application of section 171."

126. The sentence reads: "However, . . . the amount of bond premium shall not include any amount attributable to the conversion feature of the bond." Treas. Reg. § 1.171-2(c)(1) (1983).

127. *National Can*, 687 F.2d at 1113.

128. I.R.C. § 162(a) (1983). The court in *Roberts & Porter* mentioned I.R.C. § 171(b) only to add support to its holding under I.R.C. § 162. The court did not enter into a discussion of whether the section applied only to *unexercised* conversion rights in the hands of the holder.

129. *National Can*, 687 F.2d at 1113.

ible. . . .”¹³⁰ By emphasizing the acquisition of conversion rights, National Can argued that Congress did not intend to have the exclusionary provision apply to a premium paid in the form of stock issued to extinguish conversion rights.¹³¹

The court dismissed this argument on the grounds that there is nothing to indicate that Congress did not intend the exclusionary provision to apply to the situation in this case.¹³² It noted that the purpose of I.R.C. § 171 is to allow the amortization of bond premium paid because the bond bears a higher interest rate than the current market rates. In this case, “there is no relationship of the excess [premium] to any form of periodic income and thus no obvious reason to permit amortization.”¹³³ The court correctly pointed out that the interest payments received by National Can will be deductible by NCOC, a wholly-owned subsidiary. Under the consolidated return provisions in the Code and regulations,¹³⁴ this will result in a wash on the consolidated tax return. Thus, there was no reason to permit National Can to amortize any premium paid.

The court articulated another rationale for its decision based on I.R.C. § 249.¹³⁵ This section provides that a corporation which issues bonds is not permitted to deduct any premium paid to repurchase the bonds if the bonds are convertible into the stock of either the issuing corporation or of a corporation controlled by or in control of the issuing corporation.¹³⁶ The court believed I.R.C. § 249 was persuasive although National Can was not the “issuing corporation” as defined by that section. The court felt that since National Can would not have

130. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 47-48 (1950). See *National Can*, 687 F.2d at 1113.

131. *Id.* at 1113.

132. *Id.*

133. *Id.* at 1114. In effect, I.R.C. § 171 allows for an offset of interest income each year, rather than waiting until the bonds mature to recognize the loss. This process permits a more accurate approximation of the true interest income. Conversely, when a premium is paid for the conversion feature of a bond, the holder is in effect buying an option. *Id.* at 1113.

134. Treas. Reg. §§ 1.1502-11(a)(1), 1.1502-12, 1.1502-13(b)(1) (1983).

135. I.R.C. § 249 (1983).

136. I.R.C. § 249(a). This provision does not apply, however, to the extent the corporation can prove that the premium is attributable to the cost of borrowing. I.R.C. § 249(a). The term “control” is defined by I.R.C. § 368(c). I.R.C. § 249(c). I.R.C. § 368 (c) defines control as “the ownership of stock possessing at least 80 percent of the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.” I.R.C. § 368(c).

I.R.C. § 249 was enacted as a result of the Seventh Circuit’s decision in *Roberts & Porter v. Commissioner*, 307 F.2d 745 (7th Cir. 1962), which held that when a corporation repurchases its own convertible bonds at a premium, it is deductible as an ordinary and necessary business expense under section 162(a), even though the premium is attributable to a conversion feature of a bond. *Id.* at 747.

been permitted to amortize the premium if they were the issuing corporation, "logic suggests no reason for any distinction based on [National Can's use of a subsidiary to issue the debentures]."¹³⁷ The court also believed that I.R.C. § 249 was reflective of "the line Congress has consistently drawn between bond premium attributable to the interest cost of borrowing and bond premium attributable to a conversion privilege."¹³⁸

The court's reasoning regarding I.R.C. § 171 is essentially sound. It accurately reflects Congressional intent that I.R.C. § 171 apply only to a premium paid as a result of lower market rates of interest than what the bond yields. I.R.C. § 171 was not intended to apply in any other situation, either to a premium paid to acquire a conversion feature or to extinguish it. Thus, the court correctly adopted a strict construction of the exclusionary provision in I.R.C. § 171(b).

The court also analogized I.R.C. § 249 to the facts in *National Can*. It should be noted, however, that I.R.C. § 249 applies only to the *issuing* corporation. A strict interpretation of I.R.C. § 249 mandates that it does not apply to National Can under these facts.¹³⁹ Additionally, I.R.C. § 249 was enacted to remedy the situation where a corporation deducts the *entire* premium as an ordinary and necessary business expense under I.R.C. § 162, rather than amortizing the premium under I.R.C. § 171.¹⁴⁰ Thus, the court's reasoning is somewhat weak. However, it was not unreasonable for the court to apply I.R.C. § 249 to show the intent of Congress to deny deductions for amounts paid to acquire a conversion feature.¹⁴¹

In addition to its various theories under I.R.C. § 171, National Can also argued that the excess paid to acquire the bonds was an ordinary and necessary business expense within I.R.C. § 162(a).¹⁴² The court disposed of this argument quickly, by noting that "because of the fortuity of the market place . . . the difference arising on a corporation's exchange of stock having a fair market value greater than the face value is, if anything, a loss and not an expense."¹⁴³ Under I.R.C.

137. *National Can*, 687 F.2d at 1114.

138. *Id.* at 1115.

139. See *National Can*, 687 F.2d at 1115 n.5, in which the court points out that National Can probably intended to satisfy the conversion feature from the time the transaction was consummated.

140. I.R.C. § 171 (1983).

141. *National Can*, 687 F.2d at 1115-16.

142. I.R.C. § 162(a) (1983).

143. *National Can*, 687 F.2d at 1116, citing *National Can Corporation v. United States* 520 F. Supp. 567, 579 (N.D. Ill. 1981).

§ 1032¹⁴⁴ of the Code, no loss (or gain) is recognized when a corporation receives property or money in exchange for its stock.¹⁴⁵

In conclusion, the Seventh Circuit's holding strictly adheres to the exclusionary provision of I.R.C. § 171(b). The court believed that the legislative history of the exclusionary provision in I.R.C. § 171(b) mandated that bond premium amortization is permitted only when paid as a result of the bond yielding a higher rate of interest than current market rates. The court's decision also notes that because a corporation cannot recognize a loss when it acquires its own stock in exchange for property, it will not be permitted to recognize the loss by using a subsidiary.

TAX-FREE MERGERS: A REAFFIRMATION OF SUBSTANCE OVER FORM

In *McDonald's Restaurants of Illinois v. Commissioner*,¹⁴⁶ the Seventh Circuit held that what appeared to be a tax-free merger in form was in substance a purchase. McDonald's, the acquiring corporation, exchanged shares of its stock in return for the assets owned by the acquired company. The former shareholders of the acquired company then sold the McDonald's stock six months after the transaction. In reversing the tax court decision,¹⁴⁷ the Seventh Circuit held that the merger and subsequent sale of the stock should be "stepped together" and treated as a single transaction.¹⁴⁸

During the 1950's and 1960's, a group of businessmen known collectively as the "Garb-Stern Group" acquired numerous restaurant franchises from the McDonald's Corporation (McDonald's). In 1972, after relations between McDonald's and the Garb-Stern Group deteriorated, the two parties entered into negotiations whereby McDonald's would acquire all of the restaurants owned by the Garb-Stern Group. The parties differed as to how they wanted the transaction to be con-

144. I.R.C. § 1032 (1983).

145. *Id.* National Can also cited the recent decision in *International Telephone and Telegraph Co. v. Commissioner*, 77 T.C. 60, supplemented, 77 T.C. 1367 (1981). In that case, a subsidiary retired convertible bonds held by its parent corporation. The tax court held that the subsidiary was permitted a deduction. The Seventh Circuit in *National Can* held that this case was distinguishable because it involved a deduction claimed by a subsidiary. Additionally, the authorization came from the consolidated return regulations rather than I.R.C. §§ 162 or 171. *National Can*, 687 F.2d at 1116-17. The district court noted, interestingly, that National Can was a guarantor of its subsidiary's obligations. It then cited the well settled principle that a guarantor cannot deduct a loss until it proves that there is no recourse against the principal obligor. *National Can Corp. v. United States*, 520 F. Supp. 567, 580 (N.D. Ill. 1981).

146. 688 F.2d 520 (7th Cir. 1982).

147. *McDonald's of Zion v. Commissioner*, 76 T.C. 972 (1981).

148. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 525 (7th Cir. 1982).

summed. The Garb-Stern Group wanted to receive cash for their restaurants. McDonald's wanted to acquire the restaurants in return for McDonald's common stock so that they could treat the transaction as a "pooling of interests" for accounting purposes.¹⁴⁹

A plan was developed which would satisfy the needs of both sides. On the closing date of April 2, 1973, McDonald's would receive the Garb-Stern assets¹⁵⁰ in return for unregistered shares of McDonald's common stock. This would permit McDonald's to treat the transaction as a pooling of interests. Pursuant to the agreement, McDonald's would include these shares in a planned registration in June, 1973, two months after the exchange took place. Garb-Stern could participate in this registration or in any other registration that might occur within the next six years. Additionally, Garb-Stern could demand registration if it did not occur within one year. This was known as a "piggyback" registration right.¹⁵¹

Due to a decline in the market price of McDonald's stock, the June registration was delayed until October. When the registration finally took place, the former Garb-Stern shareholders immediately sold all the stock they had acquired.¹⁵²

In its 1973 tax return, McDonald's treated this transaction as a purchase.¹⁵³ This enabled McDonald's to value the new assets at essentially their fair market value rather than at their adjusted basis to the Garb-Stern Group. This created higher depreciation deductions for McDonald's. The I.R.S. disallowed these deductions, claiming that the transaction was a statutory merger under I.R.C. § 368 (a)(1)(A) of the Code, which would require McDonald's to carryover the basis that the Garb-Stern Group assets had.¹⁵⁴ The tax court agreed with the I.R.S.¹⁵⁵

149. A pooling of interests is "the uniting of the ownership interests of two or more companies by the exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained." *Id.* at 521 n.2, citing *McDonald's of Zion*, 76 T.C. at 976 n.4. It is probable that McDonald's desired to record the transaction as a pooling of interests in order to depreciate the acquired assets at their existing basis (as opposed to an increased basis). This will result in lower depreciation deductions and higher net income on their financial reports.

150. After acquiring the Garb-Stern assets, McDonald's placed them into 27 subsidiaries who were the petitioners in the tax court case. The subsidiaries have since been merged into five larger subsidiaries who are the petitioners in the instant case. *McDonald's*, 688 F.2d at 521, n.1.

151. *Id.* at 522.

152. *Id.*

153. The transaction was treated as a purchase for tax purposes but as a pooling of interests for financial accounting purposes. This practice is widely accepted. *Id.* at 522 n.6.

154. I.R.C. § 362(b) (1983).

155. *McDonald's of Zion v. Commissioner*, 76 T.C. 972 (1981).

On appeal, the Seventh Circuit began its discussion by noting that both parties agreed the "continuity-of-interest" test determines the tax treatment of the transaction.¹⁵⁶ This test examines the acquired shareholder's proprietary interest to determine if their investment remains "at risk." This means that the acquired corporation's shareholders must, at the end of the merger, be shareholders in the acquiring corporation.¹⁵⁷

The I.R.S. claimed that the application of the continuity-of-interest test should be confined to the events of April, 1973. This would result in treating the transaction as a pooling-of-interests, preventing McDonald's from acquiring the assets with a stepped-up basis.¹⁵⁸ The taxpayers argued that the "step-transaction" doctrine should apply, which would combine the April merger and the October sale of stock as one taxable event.¹⁵⁹ The step-transaction doctrine takes what is in form two transactions and treats them in substance as one transaction.¹⁶⁰ The court agreed by concluding that the transactions should be stepped together under each of the three tests contained in the step-transaction doctrine.¹⁶¹

Under the "end-result test," the courts will examine the transaction as a whole to see if it was intended to be the "end result."¹⁶² The court noted the history of the relationship between the parties and the determination of the Garb-Stern Group to sell their stock. This indicated that the final outcome was intended to be the "end result" of the transaction.¹⁶³

A second test is the "inter-dependence test." This test examines the various steps in the transaction to determine if they are so interdependent on one another that the completion of one would be useless without the completion of all the steps.¹⁶⁴ The court concluded that the

156. *McDonald's*, 688 F.2d at 523.

157. *McDonald's of Zion v. Commissioner*, 76 T.C. 972, 977 (1981).

158. *McDonald's*, 688 F.2d at 523-24. See also *Le Tulle v. Scofield*, 308 U.S. 415, 420-21 (1940); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1944); *Neville Coke & Chemical Co. v. Commissioner*, 148 F.2d 599 (3rd Cir. 1945).

159. *McDonald's*, 688 F.2d at 524.

160. See *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980).

161. *McDonald's*, 688 F.2d at 524.

162. The "end result test" is applied when "purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *Id.*, quoting *King Enterprises v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

163. *McDonald's*, 688 F.2d at 524.

164. The interdependence test decides whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Redding v. Commissioner*, 630 F.2d 1169, 1177 (7th Cir. 1980), quoting, PAUL, *SELECTED STUDIES IN FEDERAL TAXATION* 200, 254 (2d Series 1938).

transaction would not have taken place had Garb-Stern not been guaranteed the right to sell its newly acquired stock. The court pointed out that the "piggyback" agreement was very detailed in ensuring that Garb-Stern would be able to freely transfer its McDonald's stock.¹⁶⁵

A third test, the "binding commitment" test, allows the transactions to be stepped together only if there is a binding commitment that upon the completion of the first step, the latter steps must be taken.¹⁶⁶ The court stated that the stock in question was not transferrable until McDonald's registered it. Additionally, Garb-Stern had the right to demand that the stock be registered if McDonald's failed to do so. Finally, if McDonald's registered its stock during the first year and Garb-Stern failed to exercise its "piggyback" rights, then they would lose their demand rights. These limitations "made it extremely likely that the sale would—as it did—take place promptly."¹⁶⁷

In holding that the transactions were stepped together, the Seventh Circuit criticized the tax court's narrow application of the binding commitment and interdependence tests. The tax court believed that for either test to apply, Garb-Stern had to be legally bound to sell its stock.¹⁶⁸ The Seventh Circuit stated that the interdependence test was "more practical and less legalistic than that."¹⁶⁹ As for the binding commitment test, the court held that its rigorous requirements were intended for a situation where there was a span of several years between the transactions and no certainty when, if ever, they might occur.¹⁷⁰ That was not relevant in this case because the entire transaction was completed in six months and took place within a single tax year.

The court concluded by stating that "substance over form is the key."¹⁷¹ The transfer of stock and the "piggyback" agreement was arranged so that Garb-Stern could sell their McDonald's stock as soon as it was registered. This was a sound analysis by the Seventh Circuit. The regulations state that "the term ("reorganization") does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its shareholders in the property transferred."¹⁷² It is clear that the transaction was intended as a purchase and not as a reor-

165. *McDonald's*, 688 F.2d at 524-25.

166. *See* Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

167. *McDonald's*, 688 F.2d at 525.

168. *Id.* at 524.

169. *Id.*

170. *Id.* at 525, *citing* Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

171. *Id.*, *citing* Kuper v. Commissioner, 533 F.2d 152, 155 (5th Cir. 1976).

172. Treas. Reg. § 1.368-2(a) (1983).

ganization in which the Garb-Stern shareholders had a continuity of interest in the transferred assets. Even the tax court stated that "[i]n our view, the overwhelming weight of the evidence indicates that the Garb-Stern Group intended from the outset to sell their McDonald's stock at the *earliest possible moment*."¹⁷³ The tax court then listed no less than nine separate facts in support of this.¹⁷⁴ The Seventh Circuit was correct in its determination that substance must prevail over form.

In addition to the step-transaction doctrine, the court made two other points in support of the taxpayers. The first concerns the case of *Heintz v. Commissioner*.¹⁷⁵ In *Heintz*, the taxpayers had sold their business to another corporation in return for cash and stock. They were promised by the purchasing corporation that the stock would be sold within 30 days. Unforeseen difficulties arose and the sale never took place. The taxpayers later arranged a sale privately.¹⁷⁶ The tax court, in rejecting the Commissioner's contention that the transaction was a statutory reorganization,¹⁷⁷ noted that there was no plan for the taxpayers to maintain a proprietary interest.¹⁷⁸ The Seventh Circuit correctly pointed out that the taxpayers in *Heintz* were, like the taxpayers in this case, free to maintain their equity interests, and that the understandings of the parties were not embodied in a written agreement.¹⁷⁹

The other point the court made concerned the Commissioner's usual position on reorganizations. In these situations the intent of the acquired shareholders is considered relevant.¹⁸⁰ Additionally, the court pointed out that if the basis of the Garb-Stern assets had been higher than their fair market value, the I.R.S. could have refused to classify the merger as a reorganization. The court referred to this as the "heads-I-win, tails-you-lose law."¹⁸¹

The impact of this decision can be put in perspective by considering what the effect of the tax court's decision would have been. One commentator noted that the tax court opinion would have created nine new types of tax avoidance.¹⁸² The Seventh Circuit's decision removes

173. *McDonald's of Zion v. Commissioner*, 76 T.C. 972, 989 (1981) (emphasis added).

174. *Id.* at 989-90.

175. 25 T.C. 132 (1955).

176. *See McDonald's*, 688 F.2d at 526.

177. *See supra* text accompanying note 178.

178. *McDonald's*, 688 F.2d at 526, *citing Heintz v. Commissioner*, 25 T.C. 132, 142-43 (1955).

179. *McDonald's*, 688 F.2d at 527.

180. *Id.*, *citing*, Rev. Proc. 77-37, 1977 C.B. 568, 569.

181. *McDonald's*, 688 F.2d at 527.

182. *See Prusiecki, Continuity of Interest in Tax-Free Mergers: New Opportunities After McDonald's of Zion*, 55 J. TAX 378, 380 (1981).

these possibilities and returns this particular area back to the status quo.

OTHER DEVELOPMENTS IN THE LAW

Valuation of Stock in a Closely Held Corporation For Estate Tax Purposes

In *Estate of Curry v. United States*,¹⁸³ the Seventh Circuit was faced with the issue of how stock of a closely held corporation should be valued when the decedent had a majority interest in the voting stock but a minority interest in the non-voting stock. The court held that in these circumstances, the non-voting stock is worth as much per share as the voting stock.¹⁸⁴

The decedent, B.L. Curry, owned 800 shares of a total of 1,500 shares of outstanding voting stock in a closely held corporation.¹⁸⁵ Of the 4,500 outstanding non-voting shares, the decedent owned 1,360. The decedent's estate filed an estate tax return in which the voting stock was valued at \$169.14 per share and the non-voting stock at \$18.79 per share. The I.R.S. disagreed with those values and valued the stock at \$400 per share and \$300 per share for the voting and non-voting stock, respectively.¹⁸⁶ The estate paid deficiencies and brought an action for a refund in the district court. After each side presented expert witnesses on how the stock should be valued, the district court refused the government's request that the jury be instructed to value the voting stock and non-voting stock at the same amount per share.¹⁸⁷

The Seventh Circuit's holding¹⁸⁸ that the stocks should be valued at the same rate was based on the theory that because the estate tax is a tax on death and not a tax on succession, the value of the property should be determined as it exists in the estate, not on what value it has upon passing to others.¹⁸⁹ Thus, because the estate owned a controlling

183. 706 F.2d 1424 (7th Cir. 1983).

184. *Id.* at 1430.

185. All of the stock, both voting and non-voting was owned by the decedent or his children. *Id.* at 1425.

186. *Id.*

187. The requested instruction was "[b]ecause the decedent had voting control of the company, I instruct you that in valuing [decedent's] interest in the company, the non-voting stock was worth as much per share as the voting stock." *Id.* at 1426.

188. The court also: 1) rejected the government's argument that the liquidation value of the stock is the minimum value the decedent's controlling interest is worth (*id.* at 1430-32); and 2) ruled that the jury should be allowed to consider the impact of a stock purchase agreement in its valuation assessment (*id.* at 1432-33).

189. *Id.* at 1427. See *YMCA v. Davis*, 264 U.S. 47 (1924); *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

interest in the voting stock, the non-voting shares were as valuable to the estate as the voting shares. In support of this, the court also noted that under the "willing buyer-willing seller" rule,¹⁹⁰ a willing buyer would be seeking to maximize his advantage. As a result, such a buyer would not consider purchasing a non-voting interest in a closely held corporation without purchasing a controlling voting interest. Otherwise, the buyer would be at the mercy of those who owned a voting interest.¹⁹¹ Additionally, the court believed that to hold otherwise would permit various tax-avoidance schemes¹⁹² in order to undermine the estate tax system. The court then concluded that because the non-voting shares are "an integral part of the larger estate which retains a controlling equity interest, the non-voting stock would simply not be subject to the disadvantages of an isolated non-voting interest."¹⁹³

The court's reasoning in this case is not entirely sound. It is true that the owner of shares in a closely held corporation can devise schemes to avoid taxes. However, the weakness of the court's holding is in its rigidity. The court failed to take a more flexible stand by refusing to consider whether the shares of a closely held corporation are classified among voting and non-voting portions for reasons other than tax avoidance purposes. For example, an individual may give various members of his family shares of stock in the corporation while keeping the voting control to himself.

The court was also too rigid in its assumption that no one would consider purchasing non-voting stock in a closely held corporation. It is true that such stock may be unattractive, but it does not preclude a buyer purchasing it, for example, as an investment, hoping it would eventually increase in value. In conclusion, the court's holding means that an estate which owns a controlling interest in the voting stock of a closely held corporation will not receive any discount for non-voting stock.¹⁹⁴

190. Treas. Reg. § 20-2031-1(b) (1983) states that the "fair-market value is the price at which the property would change hands between a willing buyer and a willing seller . . ."

191. *Estate of Curry*, 706 F.2d at 1428-29.

192. *Id.* at 1428. One example the court gives is that an estate possessing all the shares of the corporation could "arbitrarily slice the voting share block so thinly as to deny attribution of a control premium to any resulting block." *Id.* The court also cited *Ahmanson Foundation v. United States*, 674 F.2d 761, 768 (9th Cir. 1981) as support. *Id.*

193. *Id.* at 1429.

194. In a dissenting opinion, Judge Evans believed that rather than remand the case for a new trial, the court should find as a matter of law that both the voting and non-voting stock was worth \$150.00 per share. He based this valuation on the evidence in the record. *Id.* at 1433-34.

Extraordinary Prepublication Costs Are Capital Expenditures

In *Encyclopaedia Britannica, Inc. v. Commissioner*,¹⁹⁵ payments made to David-Stewart for preparing a book called "The Dictionary of Natural Sciences" were held to be a nondeductible capital expenditure. Such payments were not ordinary and necessary business expenses that could be immediately deducted because the payments were of a non-normal, nonrecurring nature.¹⁹⁶ The test of whether the expense is recurring or nonrecurring is a "very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be."¹⁹⁷ Also, as the payments to David-Stewart were not consistent in amount, then the congressional desire to allow publishers to deduct their prepublication expenses is not applicable.¹⁹⁸ The fact the payments were unambiguously identified with a specific capital asset (the book) similarly precludes the need to immediately deduct the expenses.¹⁹⁹

Perhaps most important to the court in reaching its conclusion that the payments were nondeductible capital expenditures is the underlying economic reasoning. Judge Posner, who wrote the court's opinion, is a noted advocate of the economics-rationality school of thought.²⁰⁰ The basis of this set of beliefs is a desire of the law to reflect existing economic conditions.²⁰¹ As such, the payments in *Encyclopaedia Britannica* have to be classified as capital expenditures. To Judge Posner, the reason is obvious. "Where the income is generated over a period of years the expenditures should be classified as capital. . . ."²⁰²

To lawyers, however, this reasoning clouds the issue. The *Encyclopaedia Britannica* decision creates a dichotomy in the treatment of prepublication expenses that, prior to this case, did not exist. Authors of books are *not*, by specific congressional mandate,²⁰³ required to capitalize their prepublication costs. Hence, even though the facts may be

195. 685 F.2d 212 (7th Cir. 1982).

196. *Id.* at 217.

197. *Id.* This means that section 2119 of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1912 (1976), which calls for immediate deducting of prepublication expenses where conducted in a "consistent" manner by the taxpayer, will still apply where the payments can be shown to be of a recurring nature.

198. *Id.*

199. *Id.* at 216.

200. See POSNER, *ECONOMIC ANALYSIS OF LAW* (2d ed. 1977), for the basic theory underlying Judge Posner's taxation opinions.

201. *Id.*

202. 685 F.2d at 214.

203. See S. REP. NO. 938, 94th Cong., 2d Sess. 404-05 (1976).

the same the treatment will not be the same for authors and publishers in the Seventh Circuit.

Estimated Tax Payments on Recapture of Investment Credit

In *A.O. Smith Corporation v. United States*,²⁰⁴ the taxpayer was required to pay estimated taxes for recapture of investment tax credits. I.R.C. § 6154(a)²⁰⁵ requires that every corporation subject to taxation under I.R.C. § 11 shall make payments of estimated income tax. I.R.C. § 11 provides for the tax imposed on the taxable income of corporations.²⁰⁶ In the year in question, A.O. Smith did not have any income²⁰⁷ taxable under I.R.C. § 11, but rather had income tax liability due to recapture of investment tax credit under I.R.C. § 47.²⁰⁸

Judge Posner, writing for the court, stated that because I.R.C. § 11 is in the same chapter as I.R.C. § 47, then "section 6154(a) sweeps in all other provisions that feed through section 11, including section 47."²⁰⁹ Judge Posner further reasoned that rationality demands that the payment of recapture of the credit on an estimated basis is necessary to deny firms the incentive of disposing at the beginning of the taxable year assets subject to recapture.²¹⁰ This could constitute—in the absence of estimated payments—interest-free use of the money for an entire year.²¹¹

A pointed dissent by Judge Dumbauld, however, showed the weakness in court's reasoning. First, the rationality argument of Judge Posner is not relevant when examining tax law. "[R]ationality is not to be expected; . . . logic and justice are irrelevant; . . . tax law is 'positive law' in the classical sense of that term; . . . nothing but the expressed will of the legislator is controlling. The intent of Congress is conclusive."²¹²

The statutory reasoning of Judge Posner is similarly unconvincing. As the taxable income of A.O. Smith was zero, then for purposes of

204. 691 F.2d 1220 (7th Cir. 1982).

205. I.R.C. § 6154(a) (1983) provides in pertinent part: "Every corporation subject to taxation under section 11 . . . shall make payments of estimated tax . . . during its taxable year as provided in subsection (b) if its estimated tax for such taxable year can reasonably be expected to be \$40 or more."

206. I.R.C. § 11 (1983).

207. 691 F.2d at 1221.

208. I.R.C. § 47 (1983) provides for recapture on the premature disposition of property for which a credit has already been taken on section 38 property—property eligible for the investment tax credit.

209. 691 F.2d at 1221.

210. *Id.* at 1221-22.

211. *Id.* at 1222.

212. *Id.*

I.R.C. § 11 there was no income.²¹³ The recapture of the investment tax credit is a tax liability created under I.R.C. § 47—that is, in *addition to* the I.R.C. § 11 tax, *not a part of it*.²¹⁴ This is because the credit that is now being recaptured originally was *subtracted from* the I.R.C. § 11 tax, not a deduction entering into the computation of the I.R.C. § 11 tax.²¹⁵ Because there is no I.R.C. § 11 tax, then I.R.C. § 6154(a) will not apply.²¹⁶ Hence, there should be no requirement that A.O. Smith make estimated payments on recapture of an investment tax credit.

POSTSCRIPT

The Seventh Circuit had the opportunity tax courts dream of — shooting down taxpayers who try to skirt the law with the use of “do-it-yourself tax-planning kits.” In *Schulz v. Commissioner*,²¹⁷ the taxpayers, according to the instructions in a prepackaged kit, put virtually everything they owned in a family trust. In holding that these trusts violated several provisions of the grantor trust rules,²¹⁸ the court stated that “[i]f taxpayers persist in ignoring [rules against tax avoidance schemes], we will in the future be sympathetic to the Internal Revenue Service’s assessment . . . of penalties for underpayment of tax due to negligence or intentional disregard of the rules and regulations of the Internal Revenue Code.”²¹⁹

213. *Id.* at 1224-25.

214. *Id.* (emphasis added).

215. *Id.* at 1224.

216. *Id.* “It seems clear that the prepayment requirements in the case of corporations under section 6154 apply only to normal corporate tax computed under section 11, and not to the additional tax liability generated by reduction of a credit for premature disposition of property under section 47.” *Id.* at 1225.

217. 686 F.2d 490 (7th Cir. 1982).

218. I.R.C. §§ 671-77 (1983).

219. 686 F.2d at 490.

NOTES
&
COMMENTS

